CITY OF BERKELEY

COMMUNITY DEVELOPMENT DEPARTMENT

MEMORANDUM

September 26, 1991

To: Neil Mayer, Community Development Director

From: Stephen Barton, Senior Planner, and Steve Sekhon, Planning Intern, PPMB

Subject: OPERATING COST INCREASES AND ANNUAL GENERAL ADJUSTMENTS, 1979 - 1990

SUMMARY

Based on an analysis of consultant and Rent Stabilization Board reports we conclude that the operating cost increases granted by the Rent Stabilization Board through the Annual General Adjustment (AGA) process exceeded actual operating cost increases. This surplus served to increase Net Operating Income (NOI) and thus should be deducted from the NOI increase mandated by the Searle decision.

The surplus is estimated in two ways. First, we reviewed the reports used as a basis for the AGAs, gathered supplementary information where necessary, and compared estimated cost increases with the actual AGA rent increases. Using this method we find surplus AGA increases, with the amount of the surplus varying depending on whether the building was master metered, so that the owner paid all utilities, or individually metered so that the tenant paid utilities. For units of average rent in master metered buildings, the estimated surplus was 3.5 percent, while in individually metered buildings the surplus was 9.6 percent. The overall average surplus was 8.1 percent.

Using the Hamilton, Rabinovitz & Alschuler estimate of operating expenditures at 40 percent of rent in 1979 rent we find that if all AGAs had been used for increased operating costs they would amount to 62.5 percent of the rent for the median unit by 1990 rather than the reported 54.9 percent, a discrepancy of 7.6 percent of total 1990 rent. With the 1991 increase set at 2.2 percent higher than necessary for the average unit, this indicates an overall surplus of 9.8 percent. This confirms that the first estimate of surplus rent increases is a reasonable and conservative one.

I. BACKGROUND ON THE AGA PROCESS

Each year the Rent Stabilization Program sets an across-the-board increase in rents, the Annual General Adjustment (AGA). This increase is intended to cover increases in operating costs and maintain the remaining net operating income (NOI) at a constant amount. From 1982 to the present the Rent Board has commissioned consultant studies of operating cost increases to inform its decisions on the level of increase to allow in the following year. These studies are the best available estimates of actual operating cost increases. In 1980 and 1981 data on cost increases was gathered, but the methods used were less accurate than those established by the 1982 consultant report, and in 1979 the increase to be allowed in the following year was simply set arbitrarily as part of a temporary rent stabilization ordinance.

In order to use this material to estimate operating cost increases, the increases set in 1980 and 1981 need to be placed on a basis consistent with those set in 1982 on, and we must estimate the appropriate level for the increase set in 1979.

METHOD OF DETERMINING RENT INCREASES NEEDED TO COVER OPERATING COST INCREASES

The basic method used by the Rent Stabilization Board for determining the rent increases needed to cover operating cost increases is as follows. In studies done in 1982 and again in 1989 the average proportion of rent going to operating costs was determined, as well as the average proportion of rent used to cover each of eighteen different types of operating costs. In addition, in 1982 and each subsequent year consultants have gathered data to determine the rate of increase in each of eighteen different cost categories in the previous year. They use a variety of sources, including surveys of owners, contacts with government and utility companies, and use of the Consumer Price Index to estimate maintenance costs. The increase in cost in each category is then multiplied by the proportion of rent used to meet the previous year's costs in that category for the average unit. This gives the percentage of rent increase needed for the next year for the average unit in order to cover that increase in costs. The increases for each cost category can then be added up to determine the total percentage rent increase needed for that year. (Attachments: 1982-1990 AGA consultant reports.)

The Rent Stabilization Board usually set percentage rent increases closely based on the total of the increased costs as a percentage of rent. In 1987, 1989 and 1990 fixed dollar increases were granted. These gave units with lower than average rents a higher than average percentage increase and units with higher than average rents a lower than average percentage increase. The Board felt that buildings with concentrations of lower rent units generally had operating costs that were a higher than average proportion of rents, while buildings with concentrations of higher rent

units generally had operating costs that were a lower than average proportion of rents. Giving flat dollar increases set at the average operating cost increase for all units thus makes the operating cost increase more closely reflect actual operating cost increases for units above and below the average.

Because utility costs often increased at a faster rate than other costs, in 1981, 1982, 1983, 1986 and 1989 the Rent Board set higher increases for buildings in which the owner pays gas or electricity. These owners had utility costs that were a higher proportion of total rent than for owners whose tenants paid all or most utilities. Most of the reports over the ten year period summarize cost increases in two categories: individually metered buildings and master metered buildings, and the Board makes the reasonable assumption that master metered buildings are those in which the owner pays utilities and that individually metered buildings are those in which the tenant pays.

It is a straightforward matter to determine the relationship between operating costs and AGA rent increases for the increases based on the consultant reports. All that is necessary is to total up the recommended AGA increases and compare the total recommended AGA with the AGA that was actually granted. That is what is shown in the tables below for the rent increases set in 1982-90. (We have modified the recommendations in the 1982 report to take into account a change in the way the Consumer Price Index was computed that took effect in 1983. This modification is discussed in the Appendix.)

As the Rent Board has recognized, cost increases are often substantially different in master metered and individually metered buildings. Thus we present separate increase totals for each. According to Rent Board records, of the 19,182 rented units which are subject to rent control in August of 1991, landlords pay for gas, electricity, or heating in 4,672 units - approximately 24%, while tenants pay for utilities in 76% of the units.

In estimating the cost increases for individually metered buildings we must also deal with the difference between landlords who pay for heating and lighting in common areas and those who pay no utility costs at all. Since the Rent Board never granted separate increases for these two categories we have averaged them together. According to the 1982 AGA study by Kenneth Baar and associates (Sept. 2, 1982, page IV-25) the majority of landlords of individually metered buildings pay no common utilities at all, but since an exact figure was not given we have taken the more conservative approach and simply averaged the two situations together as if they covered equal numbers of units.

Estimating cost increases is a more complex process for the 1979, 1980 and 1981 increases, before a standard method was established by Baar and associates. We have estimated cost increases for 1979 using the ratio of the increase in costs to the increase in Consumer Price Index reported in all subsequent years. We used the reports from 1980 and 1981 but made changes necessary to approximate use of methods consistent with the methods used from 1982 to the present.

A detailed description of how operating cost increase reports were analyzed is given in the Appendix.

CUMULATIVE DIFFERENCES BETWEEN ESTIMATED OPERATING COST INCREASES AND AGA INCREASES

The Summary Table shows the cumulative difference between AGA increases and those recommended by the yearly reports for this median rent unit, with the figures separated out by whether the increase is for properties with master or individual utility meters.

After eleven yearly AGAs, the median rent unit has a rent that is 9.56% percent greater than the adjusted rent using the best available estimate of actual operating costs for individually metered buildings. In other words, the AGAs raised the 1979 median of $233.33 to $390.38 in 1991 and this is $37.09 higher than was necessary solely to meet estimated operating cost increases. The total difference to date, between the AGAs and those recommended for master metered buildings, is 3.54 percent of current rent.

According to figures from the Berkeley Rent Stabilization Board, 76 percent of the tenants in Berkeley pay for gas and electricity (figures confirmed in the 1990 mail-out). These percentages were similar at the beginning of rent control, according to a 1980 CalPIRG survey which found that 78 percent of renters paid for their own gas and 82% paid for their electricity. About 24% of controlled units are in master metered so that the landlord pays gas and or electricity. Using this ratio we can compute that the average difference between rent increases granted and cost increases for all rentals together is 8.06 percent of current rent.

SUMMARY TABLE OF AGA INCREASES VS. REPORTED COST INCREASES

YEAR	AGA Ind. Mtr.	AGA Master Mtr.	Reported Increase-IM	Reported Increase-MM	AGA less Reported Ind. Meter	.AGA less Reported Master Mtr
1979						
1980	5.00%	5.00%	3.60%	4.43%	1.40%	0.57%
1981	5.00%	6.20%	4.11%	4.44%	0.89%	1.76%
1982	9.00%	12.00%	5.39%	7.29%	3.62%	4.71%
1983	4.75%	5.00%	4.40%	6.31%	0.35%	-1.31%
1984	0.00%	0.00%	2.40%	2.49%	-2.40%	-2.49%
1985	2.00%	2.00%	2.65%	2.98%	-0.65%	-0.98%
1986	3.83%	3.80%	3.48%	4.00%	0.35%	-0.20%
1987	3.50%	3.50%	3.70%	3.48%	0.14%	0.02%
1988	7.76%	7.46%	6.41%	6.56%	1.36%	0.90%
1989	3.00%	3.50%	1.51%	2.45%	1.50%	1.05%
1990	4.48%	4.29%	2.85%	5.00%	1.63%	-0.71%
1991	4.55%	4.37%	1.78%	3.60%	2.78%	0.77%
1979-1991 Cumulative	67.31%	73.96%	51.31%	67.81%	16.00%	6.16%
Surplus AGA increase as percent of 1991 rent.					9.56%	3.54%

AGA percentage increases above assume a starting 1979 rent of $233.33. This is the 1980 Census median of $245 minus the 1980 allowable increase of 5%.

AGA as % corrected CPI
72.6% Individual Meter
79.8% Master Meter
74.4% All Units

AGA as % reported CPI
65.3% Individual Meter
71.7% Master Meter
66.9% All Units

WERE RENT INCREASES ACTUALLY USED TO MEET OPERATING COST INCREASES?

In 1982 and again in 1989 the Rent Board consultants did detailed surveys of property owner's operating cost expenditures and developed estimates of the average amount of rent going to operating costs and to net operating income. Using this material, Hamilton, Rabinovitz & Alschuler present 1981 and 1990 average operating costs as a percentage of rent on page 24B of their report of July 30, 1991, "Inflation Indexing in Berkeley Rent Regulation in the Aftermath of the Searle Decision".

This allows us to check on the extent to which rent increases have in fact been used entirely for operating cost increases. The procedure is shown in the table below. The 1981 operating cost is 44.1 percent of rent. Using the median rent unit and taking the AGA increases granted up to 1990 we apply all of the increase in rents to operating costs while holding net operating income constant as the rent law implies. This procedure should lead to a substantial increase in operating expense percentage, from 44.1 percent to 61.4 percent of rent.

Since the 1990 average operating costs are reported as 54.9 percent, this reveals that 6.6% of the rent, which supposedly was for increased operating costs incurred between 1981 and 1990, is actually going to increased net operating income. This is higher than found in our analysis of differences between AGA and recommended increases for the same period. It is lower than the total of 9.5 percent because the data does not include surplus AGA increases that took effect in 1980 and 1991. With these added in the total would be 11.1 percent of the rent.

Using the Hamilton, Rabinovitz & Alschuler estimate of 1979 operating expenditures at 40 percent of rent and NOI at 60 percent, we find that if all AGAs had been used for increased operating costs they would amount to 62.5 percent of the rent by 1990 rather than the reported 54.9 percent, a discrepancy of 7.6 percent of total rent by 1990. With the 1991 increase set at 2.2 percent higher than necessary for the average unit, this indicates an overall surplus of 9.8 percent. Thus the available data on trends in operating costs and NOI confirm first, that for the average unit NOI was not held to a constant dollar amount by the operation of the Berkeley Rent Stabilization Ordinance and second, that the estimate of surplus rent increases is a reasonable and conservative one.

PROJECTED OPERATING EXPENSES FOR A MEDIAN RENT UNIT IN BERKELEY

	HRA Assumptions for 1979	HRA Analysis of 1981 Report	HRA Analysis of 1990 Report
Operating Expense Percentage, 1979	40%		
Operating Expense Percentage, 1981		44.1%	
Operating Expense Percentage, 1990			54.9%
Median Rent	$233.33	$257.25	$373.38
Operating Expense	$93.33	$113.45	$204.99
Net Operating Income (NOI)	$140.00	$143.80	$168.39

1990 NOI - 1979 NOI = $28.39 or 7.6% of 1990 rent.

1990 NOI - 1981 NOI = $24.59 or 6.6% of 1990 rent.

Sources:
a) Median Rent based on 1980 Census median for Berkeley of $245 and adjusted by AGAs granted.
b) 1981 and 1990 Operating Cost Percentage come from Hamilton, Rabinovitz and Alschuler (HRA), "Inflation Indexing in Berkeley: Rent Regulation in the Aftermath of the Searle Decision, July 30, 1991, page 24B and are based on a reanalysis of the 1982 Baar report and the 1990 Gruenstein report.
c) The 1979 Operating Cost Percentage comes from HRA, "Rationale for Determination of 1979 Operating Ratio for Rent Controlled Apartments in Berkeley", September 10, 1991 and is the figure the Rent Stabilization Board use in computing the Searle increase.

APPENDIX: DESCRIPTION OF METHOD

This appendix explains calculations and assumptions made in the text regarding increases in operating expenses and Annual General Adjustments (AGAs). After the text summarizing each year's increases follows the summary page, as produced by the consultants, along with any changes for individual line items placed next to that line item in parenthesis.

AGA Percentages

When AGA increases are done as fixed dollar amounts, percentage increases are calculated as follows: the 1980 median rent of $245, as reported by the 1980 Census, is adjusted by all applicable Annual General Adjustments and the dollar increase is divided by this base amount to determine the percentage increase. The utility allowance increase, if a fixed dollar amount, was similarly converted to a percentage of the previous year's adjusted rent and then added to the general AGA for the Master Metered column.

An example may help to make the calculation from dollar increases to percentage increases clear. In 1982 the AGA was 9% with an additional $7 increase allowed for one bedroom units and $9 for two bedroom units in which the landlord paid for gas and electricity, including heating. According to the 1980 Census the median rent in 1980 was $245 and 60% of rentals were one bedroom or less while 40% were two bedrooms or more. After the 1981 increase of 6.2% for buildings where the landlord pays for gas and electricity the median rent comes to $260.19. The utility increase is averaged to $7.80, sixty percent of the difference between $7 for a one-bedroom and $9 for a two-bedroom, and this amounts to an additional 3.0% increase bringing the total AGA for units in which the landlord pays the utilities, to 12.0%.

Consumer Price Index

CPI increases play an important role in the cost increase studies because several major cost components, including maintenance, are estimated using the increase in CPI. (Actually the CPI-U, where "U" stands for All Urban Consumers). Since 1982 the consultants have used the increase in CPI from June of the previous year to June of the year in which the increase is set. June to June CPI increases are roughly equivalent to Annual Average to Annual Average increases over any given year and the two are nearly identical over several years. June to June, however, is available much sooner and thus is more practical for the Rent Board to use.

The 1980 AGA report used October to October, while the 1981 AGA report used August to August, and the 1982 report finally settled on June to June, which has been used by all subsequent AGA studies. This resulted in overlap between the time periods used in the earliest studies. For this reason we have redone cost increase estimates based on CPI in the 1980 and 1981 AGA reports to use consistent June to June increases for the early years.

There are further complications in use of CPI data. For the period prior to 1983 the CPI is on a different basis than in 1983 and after. In January 1983 the Bureau of Labor Statistics changed the way it estimated increases in housing costs in order to take out the effects of increasing home purchase prices and variations in mortgage interest rates. Economists felt that since only a small percentage of homeowners bought new homes in any given year the previous method overstated inflation. The new method estimated the rental value of owner-occupied housing along with tracking rents in rental housing. In addition, the 1980 report used CPI less energy and the 1983 report used CPI less shelter. We have placed all CPI data on a consistent basis except for the 1983 report. Here the use of the CPI-All Items, which went down, would lead to a reduction in estimated costs rather than the increase generated by use of the CPI-less shelter and thus would unrealistically reduce the recommended rent increase. Indeed, the decrease may be an artifact of the revision in measurement of CPI housing costs that took place in January 1983.

In order to use consistent CPI data, then, we need to take the change in measurement of housing cost inflation into account for the increases set in 1979 - 1982. On a national level the Bureau of Labor Statistics kept both regular CPI data and data on increases under the experimental index that served as the basis for the revised CPI until the change was made in January 1983. We estimated a Bay Area CPI-U-X1 increase for the years 1978 to 1982 by taking the ratio of the United States CPI-U to the United States CPI-U-X1 and applying that ratio to the Bay Area CPI-U. This gives an estimated Bay Area CPI-U-X1 with the same relationship to the Bay Area CPI-U as the U.S. CPI-U-X1 has to the U.S. CPI-U. This is a conservative method of estimating a Bay Area CPI-U-X1. Since home price inflation was much more rapid in the Bay Area than nationally during that period, the difference between the two indices in the Bay Area would probably have been much larger.

June-June	Increase in U.S. CPI-U	Increase in U.S. CPI-U-X1	Ratio of CPI-U to CPI-U-X1
1978-79	10.89%	9.32%	1.168
1979-80	14.38%	10.96%	1.312
1980-81	9.55%	9.51%	1.004
1981-82	7.06%	6.46%	1.093

June-June	Increase in Bay Area CPI-U	Imputed Increase in Bay Area CPI-U-X1
1978-79	6.64%	5.68%
1979-80	16.79%	12.79%
1980-81	10.41%	10.37%
1981-82	11.22%	10.27%

The CPI data for 1978 to 1982 have been re-estimated using this procedure, and the revised CPI figures used in the 1980 and 1981 Rent Board reports and the 1982 Baar and associates report. Thus, where CPI-all items data was used to estimate increases in maintenance and management costs we have used the June to June CPI data rather than October to October or August to

August and have re-estimated CPI based on the CPI-U-X1 in order to be as consistent as possible with the consultant reports done from 1983 to the present.

(Attachments: "Questions and Answers on Homeownership Costs" U.S. Department of Labor, Bureau of Labor Statistics (BLS), January 1983; "Experimental Measures: CPI-U X1: All Items", BLS, February 26, 1988; "Consumer Price Index, All Urban Consumers", BLS, July 17, 1991)

Treatment of Ranges

In most cases the consultants did not give a recommended increase, but rather a list of operating costs and weights for each cost. In these cases we have totaled up the list of costs. Sometimes the estimated cost increase is given as a range rather than a set amount. Usually the range is a small one and the midpoint of the range was used. In one case, explained under the 1985 report, survey responses were was used to decide what part of the range was appropriate to use.

1979 decision on 1980 rent increase.

In 1979 a temporary rent ordinance was passed that allowed property owners an increase of up to 5% in 1980. There was no analysis of actual operating cost increases. In order to estimate cost increases we have taken the ratio of the increase in operating costs from 1979 to 1990 (the period for which cost studies do exist) to the increase in the Bay Area Consumer Price Index (CPI-U) for the same June 1979 to June 1990 period (modified as described above for the pre-1983 period). The cost increase was then computed by multiplying this ratio by the estimated Bay Area CPI-U-X1 increase for the previous year, June 1978-June 1979. This approximates the likely increase in operating costs by following the normal pattern established over the next ten years. This procedure was used separately for individually metered and master metered buildings and came to 4.43% for master metered and 3.60% for individually metered buildings.

Since the Rent Board has only certified rents for 1980, not for 1979, the Rent Board and its consultants assume that the 1980 rents are 5% greater than market rents in 1979 and we have followed this practice. Some property owners have argued that assuming the 5% AGA increase for 1980 is not fair because it was not an automatic increase and not all landlords increased their rents. Some tenants, on the other hand, argue that many property owners, perhaps unaware of their legal obligations, took more than the legal increase. One way to deal with the arguments over this is to allow Individual Rent Adjustments where the landlord or tenant can prove rents did not increase by 5% in 1980.

1980 report for the 1981 AGA increase.

The AGA increase in 1981 was based on a simple and incomplete study of operating expense increases in the 1978-79 period. The CPI less energy for October 1979 through October 1980 was used in the report. In the computation of the increase in costs we used the June 1979 to June 1980 Bay Area CPI All Items and then converted it to a Bay Area CPI-U-X1. This increased the inflation multiplier for maintenance and operating expenses to 12.8% from 12%.

The 1980 report also failed to make a distinction between the operating costs of individually metered buildings and buildings with master meters. Based on the relative costs of gas and electricity for master metered buildings and individually metered buildings in the 1982 report, we calculated the energy costs for both types of buildings.

The Rent Board used data from a Santa Monica survey of landlords to determine the weight to give each cost. Santa Monica rents apparently had a lower proportion of operating costs and a higher proportion of NOI than Berkeley properties, so that use of this weighting worked against Berkeley landlords. We have used the 1982 Berkeley survey data to work out a more appropriate weighting.

We have also used energy cost increases as reported by the Pacific Gas and Electric Company, which serves Berkeley, rather than the 74% Bay Area CPI increase for energy costs as was used in the Board's 1980 study. The Pacific Gas and Electric Company reported that the increase in gas for 1979-80 was 56.5%, while the electricity costs actually decreased by 20%. The relative weight of the gas and electricity costs were then imputed to arrive at a weighted total increase in energy costs for both individually and master metered buildings.

Finally, the AGA committee recommended that their suggested 4.23% increase be rounded to 5% to take into account cost increases resulting from the Measure E/Measure Y special tax changes and the EBMUD sewer rate increases, rent registration fees, and any estimating errors made. In keeping with the expressed sense of the size of the mentioned expenses and errors, we have also included, in the recalculated recommended figures, the same .77% cushion.

This brings the 1981 AGA cost increases for buildings with master meters to 4.20% and 4.00% for individually metered buildings.

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